

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petitions	:	
of	:	
AR & RA FOODS, INC.	:	DETERMINATION
AND ALAN REICH, AS AN OFFICER OF	:	
AR & RA FOODS, INC.	:	
for Revision of Determinations or for Refund	:	
of Sales and Use Taxes under Articles 28 and 29	:	
of the Tax Law for the Period June 1, 1983	:	
through November 30, 1986.	:	

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Petitioners, AR & RA Foods, Inc., and Alan Reich, as an officer of AR & RA Foods, Inc., 528 South Broadway, Hicksville, New York 11801, filed petitions for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period June 1, 1983 through November 30, 1986 (File Nos. 805765 and 805771).

A hearing was commenced before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on December 4, 1989 at 1:15 P.M. and was continued to conclusion at the same location before the same Administrative Law Judge on February 6, 1990 at 1:15 P.M., with all briefs to be filed by July 15, 1990. Petitioners appeared by Cole, Hartman & Company, Inc. (Lawrence R. Cole, C.P.A.). The Division of Taxation appeared by William F. Collins, Esq. (Angelo Scopellito, Esq., of counsel).

ISSUES

I. Whether, as the result of a field audit, the Division of Taxation properly determined additional sales tax due against petitioner AR & RA Foods, Inc. and against petitioner Alan Reich as an officer thereof.

II. Whether, if so, petitioners have nonetheless established any basis warranting reduction or cancellation of penalties imposed.

FINDINGS OF FACT

On March 17, 1986 the Division of Taxation ("Division") issued a letter to petitioners, AR & RA Foods, Inc. and Alan Reich, advising that a field audit of the corporation's sales and use tax returns for the period "June 1, 1983 through the present" was to be conducted.<sup>1</sup> This letter scheduled the field audit for April 3, 1986 and stated that "all books and records pertaining to your Sales Tax liability for the period under audit should be available. This would include journals, ledgers, sales invoices, purchase invoices, cash register tapes, exemption certificates and all Sales Tax records. Additional information may be required during the course of the audit." An attached check list provided further specifics as to those records which would be required to be available for audit. Petitioners' accountant responded to this letter and, after certain delays at his request, the audit was actually commenced on July 8, 1986.

The auditor reviewed petitioners' records, noting that petitioners lacked certain source documents pertaining to sales. More specifically, petitioners did not retain any cash register tapes nor did petitioners have any guest checks or sales invoices. The auditor also noted that since petitioners made payouts from the cash register for certain purchases and since purchase invoices were not

sequentially ordered, it was not possible to verify, despite petitioners' assertions to the contrary, whether all purchase invoices were in fact present. The auditor thus determined petitioners' records to be insufficient for purposes of conducting an audit or verifying taxable sales and sales tax liability. Accordingly, the auditor decided to resort to indirect auditing methodologies, in this case an observation test of taxable sales, as a means of determining petitioners' sales tax liability. Petitioners' representative was advised that an observation test would be conducted on Thursday, October 6, 1986 from the time the business opened until approximately 5:00 P.M.

Petitioner AR & RA Foods, Inc. operates a delicatessen, selling cold cuts, sandwiches,

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<sup>1</sup>Testimony at hearing clarified that the audit period "June 1, 1983 through the present" was meant to span the period June 1, 1983 through the sales tax quarterly period ending most immediately before the audit letter's March 17, 1986 issuance date -- i.e. the quarterly period ended February 28, 1986.

salads, coffee, cigarettes, soda and certain grocery items. On the day of the observation, the auditor and one assistant recorded taxable sales of \$978.90. Gross sales as recorded in petitioners' "day book" totalled \$1,589.95. The auditor noted initially that such gross sales were 177.5% greater than average daily reported gross sales (reported gross sales divided by the total number of days in the audit period).

In conducting the audit, the following methodology and computations were employed:

- (a) A review of daily gross sales per petitioners' day book for the months of January and July 1984 was made to calculate the percentage of each day's gross sales to total weekly gross sales. Thursday sales were calculated as 16.36% of weekly sales.<sup>2</sup>
- (b) Gross sales on the (Thursday) observation day (\$1,589.95) were divided by the Thursday percentage of weekly gross sales (16.36%) to arrive at weekly gross sales of \$9,718.52. This latter figure was multiplied by the 182 weeks in the audit period to arrive at audited gross sales of \$1,768,771.00.
- (c) Taxable sales of \$978.90, as observed, were adjusted for each day's percentage of sales (see Finding of Fact "4-a") to arrive at taxable sales for each day of the week. The resulting adjusted daily amounts were totalled to arrive at weekly taxable sales of \$5,211.14. This figure was multiplied by the 182 weeks in the audit period resulting in audited taxable sales of \$948,427.00.
- (d) Audited taxable sales (\$948,427.00) compared to audited gross sales (\$1,768,771.00) results in a taxable ratio of 53.6%. Such percentage was applied to audited gross sales, as allocated per quarterly period, to obtain audited taxable sales per quarter and, in turn, tax due was computed thereon. After allowing credit for tax paid, the liability at issue herein remained.

Between the date of the observation test and the ultimate issuance of the deficiencies in question (see Finding of Fact "6", *infra*) the auditor and petitioners' representative had various conversations. The auditor offered to perform a second observation test, which offer was rejected by petitioners' representative as too disruptive to petitioners' business. The auditor also testified, although vaguely, about requesting additional records for the last three quarterly periods at issue herein, including a May 6, 1987 request for "more periods of the 1986 day

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Determining such daily percentages and adjusting thereafter was done to allow for petitioners' claim that Thursday (the day of observation) was a comparatively heavy sales day.

books." This latter request was met with the response that such day books had not been completed and/or were not available. No further specific evidence was presented with regard to requests for records vis-a-vis extending the audit period. The auditor utilized the same method and percentages in calculating tax due for the last three quarterly periods as was used for the balance of the audit.

On June 11, 1987, the Division of Taxation issued two notices of determination and demands for payment of sales and use taxes due to petitioner AR & RA Foods, Inc. for the audit period spanning June 1, 1983 through November 30, 1986. The first of these notices assessed tax due for such period in the amount of \$35,071.59, based on the above-described field audit results, plus penalty (Tax Law § 1145[a][1][i]) and interest. The second such notice assessed additional "omnibus" penalty only (Tax Law § 1145[a][1][vi]), for the period June 1, 1985 through November 30, 1986. On the same June 11, 1987 date, the Division of Taxation also issued two notices of determination to petitioner Alan Reich, as an officer of AR & RA Food Co., Inc., identical in amount, period covered and penalty imposition to the two notices issued to the corporate petitioner. The record reveals that validated consents had been executed prior to issuance of the notices such that the timeliness of their issuance is not in question.

Petitioners did not maintain cash register tapes, guest checks, sales invoices or any other records of individual sales. Rather, petitioners entered total sales from the cash registers' daily summary total into a day book (which day book was available at least for a portion of the audit period and was utilized by the auditor as noted). Petitioners' method of filing sales tax returns was to take total sales per quarter from the day book, delete therefrom the amount of sales tax included therein, and apply an estimated taxable ratio thus computing taxable sales and sales tax thereon. Petitioners determined the taxable ratio by totalling and comparing taxable and gross sales for three days each year. Petitioners' taxable ratio as applied during the period at issue ranged from 45% to 50%.

Petitioner Alan Reich is the president and sole shareholder of petitioner AR & RA Foods, Inc. At hearing, petitioner Alan Reich admitted that he was a person under a duty to

collect and remit sales and use taxes on behalf of petitioner AR & RA Foods, Inc., and conceded his personal liability for any taxes determined to be due herein.

#### SUMMARY OF THE PARTIES' POSITIONS

Petitioners argue that the records maintained were adequate for purposes of conducting an audit based thereon. More specifically, petitioners maintain that all purchase invoices were kept and were available, and that a markup of 63%, as derived from petitioners' Federal income tax returns, was admittedly accepted by the auditor as a reasonable markup for a deli of petitioners' type, and should have been applied to petitioners' total purchases to determine total sales. In essence, petitioners argue that a markup audit should have been performed. In addition, petitioners argue that the extension of the audit period for any periods beyond February 28, 1986 was erroneous. Finally, petitioners request, in any event, that penalty be abated. In this vein, petitioners argue that petitioner Alan Reich had little education or experience in accounting or, specifically, in tax matters.

The Division argues, by contrast, that petitioners' books and records were incomplete, specifically with regard to records of sales as described, thus entitling resort to indirect audit techniques. Further, the Division asserts that the nature of petitioners' recordkeeping, coupled with the magnitude of underreporting as determined on audit, supports the imposition of penalty.

#### CONCLUSIONS OF LAW

A. Tax Law §§ 1135 and 1142(5) provide that a vendor, such as the corporate petitioner herein, is under a duty to maintain complete, adequate and accurate records of its sales and to make the same available for audit upon request. Tax Law § 1138(a)(1) further provides that where adequate records are not maintained or made available, the Division of Taxation is entitled to resort to indirect methodologies, including external indices, in conducting audits and determining the accuracy of a taxpayer's returns as filed.

B. Petitioners do not specifically challenge the Division's right to resort to an indirect audit method in this case. In fact, petitioners' own method of filing was largely based on

estimates. Rather, the essence of petitioners' argument is that the Division "could and should" have performed a markup audit. In any event, it is clear that the corporation's sales records were inadequate, given the lack of cash register tapes, guest checks, sales invoices, or any other "records of every sale and the tax due thereon", and thus the use of an indirect audit method was appropriate (Matter of Licata v. Chu, 64 NY2d 873, 487 NYS2d 552; Matter of Vebol Edibles, Inc. d/b/a Hickory House, Tax Appeals Tribunal, January 12, 1989). Therefore, the only remaining issue with regard to the audit is whether the particular method employed, or the results thereof, were irrational or erroneous.

C. Petitioners have the burden to establish by clear and convincing evidence that the audit method was erroneous (Matter of Surface Line Operators Fraternal Organization, Inc. v. Tully, 85 AD2d 858, 446 NYS2d 451). At hearing, petitioners asserted that all purchase invoices were available and that application of the markup computed per Federal income tax returns would yield a more accurate reflection of total sales. However, petitioners did not establish any particular errors in the results of the observation test utilized.<sup>3</sup> Petitioners' allegations, specifically

that a different indirect audit method could have been used, without more, are insufficient to warrant any adjustment to the audit findings (Matter of Mera Delicatessen, Inc., Tax Appeals Tribunal, November 2, 1989; Matter of Vebol Edibles, Inc. d/b/a Hickory House, *supra*; Matter of Alleto Corporation, Tax Appeals Tribunal, November 17, 1988). The fact that a different method might have given a better picture of the corporation's business and thus its tax liability

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<sup>3</sup>Petitioners argued that since the auditor utilized gross sales as recorded in the day book on the observation day rather than directly recording gross sales, the audit is flawed, or at least the overall accuracy of the day books is confirmed. This argument is rejected. As to using the day book gross sales total on the observation day, it is reasonable to assume that a taxpayer would endeavor to record an accurate total of sales when an auditor is on the premises conducting an observation audit. Hence, use of the gross sales total per day book on the observation day is acceptable. As to such use serving to validate the overall accuracy of the day books, recorded gross sales on the observation day were 177.5% greater than average daily reported gross sales, thus clearly calling to question the overall accuracy of the day books.

does not satisfy petitioners' burden to establish that the method of audit or the amount of the tax assessed was erroneous (Matter of Club Marakesh, Inc. v. State Tax Commission, 151 AD2d 908). Where a taxpayer's own failure to maintain adequate, accurate and complete books and records requires resort to indirect audit techniques, exactness is not required of the Division of Taxation in arriving at its determination, and the consequences of recordkeeping failures in this regard weigh heavily against the taxpayer (Matter of Meskouris Brothers, Inc. v. Chu, 139 AD2d 813, 526 NYS2d 679). Accordingly, the audit procedures described herein are sustained (see, Matter of Meskouris Brothers, Inc. v. Chu, *supra*; Matter of Gaetano Vendra d/b/a Pete's Pizzeria, Tax

Appeals Tribunal, February 9, 1989; Matter of Vebol Edibles, Inc. d/b/a Hickory House, *supra*).

D. Notwithstanding the foregoing, however, the audit period specified in the audit appointment letter for which records were requested spanned "June 1, 1983 through the present". As noted, the "present" was intended to mean through February 28, 1986 (see, Footnote "1"). There is no clear evidence that the auditor requested (or reviewed) records for any subsequent period. The testimony regarding any such request was equivocal at best (e.g., "we had some conversations" and "we asked for more periods of 1986 day books"). While it is doubtful that adequate records were maintained during the last three quarterly periods at issue herein, petitioners were nonetheless entitled to know that the audit period was being extended and to be asked specifically for records pertaining to such extended period. The record herein leaves in question the nature of what request for records was made of petitioner. Without clear evidence of a request for (and subsequent review of) records for the period March 1, 1986 through November 30, 1986, the Division of Taxation exceeded its authority in assessing petitioners for such period (Matter of Adamides v. Chu, 134 AD2d 776, *lv denied* 71 NY2d 806; Matter of Anton's Car Care Service, Inc., Tax Appeals Tribunal, November 23, 1988). Hence, the last three quarterly periods assessed herein are cancelled.

E. Petitioners have not adduced evidence of facts or circumstances which would warrant

reduction or cancellation of the penalties imposed (see, 20 NYCRR 536.5[d][1]) and thus such penalties (except insofar as eliminated for the last three quarterly periods at issue) are sustained.

F. The petitions of AR & RA Foods, Inc. and Alan Reich, as an officer of AR & RA Foods, Inc., are granted to the extent indicated in Conclusion of Law "D" but are in all other respects denied and the notices of determination and demands for payment of sales and use taxes due dated June 11, 1987, as recalculated in accordance with this determination, together with such penalty and interest as is lawfully due and owing, are sustained.

DATED: Troy, New York

ADMINISTRATIVE LAW JUDGE